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Introduction

he Department of Finance has been required to provide a tax expenditure report to the Legislature since 1971. Chapter 1762, Statutes of 1971, required that a biennial report be submitted to the Legislature. Chapter 268, Statutes of 1984, increased the reporting frequency from once every two years to once a year. The required report includes each of the following:

- A comprehensive list of tax expenditures.
- Additional detail on individual categories of tax expenditures.
- Historical information on the enactment and repeal of tax expenditures.

This report fulfills the Department's statutory requirement pursuant to Government Code Section 13305.

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Definitions

here is no absolute rule for defining tax expenditures, and the concept of a "tax expenditure" can be defined in several different ways. For the purposes of this report, the Department has chosen to define a tax expenditure as any special provision in the tax law that results in the collection of fewer tax revenues than would be collected under the basic tax structure. This report is also intended to identify only tax expenditures with large revenue effects in order to focus attention on those areas of the tax structure with major fiscal significance.

Although broad, this definition does exclude several provisions of the tax law from classification as tax expenditures.

Because the basic structure of each tax is used as the starting point for determining what constitutes a tax expenditure, elements of the basic tax structure that exempt certain groups are not considered tax expenditures. For example, the sales tax is imposed on retailers for the privilege of selling tangible personal property at retail. According to its basic definition, California's sales tax does not apply to sales or leases of real property, sales of services, wholesale transactions, or sales of securities and insurance. These exemptions are therefore not considered tax expenditures. They are elements of the basic tax structure.



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- Across-the-board tax rate reductions do not represent tax expenditures. Tax expenditures resulting from changes in the rate structure only exist if different sets of rates are applied to a similar base.
- Progressive rate structures do not constitute tax expenditures. The basic structure of California's income tax is progressive. For that reason, application of different tax rates to different income levels is a basic characteristic of the tax and does not represent a tax expenditure.
- Exemptions or exclusions required by the U.S. Constitution, the California Constitution, or federal laws are not considered tax expenditures.
- Changes in tax law that alter penalties or interest or that accelerate or defer tax payments are generally not considered tax expenditures unless they are very narrowly targeted.

However, the definition of "tax expenditure" is subject to debate, and there is no single rule for determining what constitutes an element of the basic tax structure or defining how costly an expenditure must be for inclusion. For these reasons, this report may exclude items that are included in other tax expenditure reports and vice versa.

Why Adopt Tax Expenditures

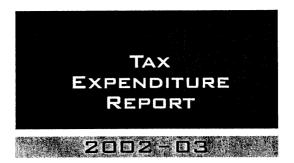
ax expenditures may be classified into the follow-

ing four broad groups:

- Those which conform California tax law to federal provisions.
- Those intended to remove perceived inequities in the basic tax structure.
- Those intended to ease tax administration.
- Those which grant targeted tax reductions through exemptions, credits, deductions, or exclusions.

There are several differences between tax expenditures and direct expenditures (those authorized through the budget process). First, tax expenditures are reviewed less frequently than direct expenditures once they are in place. This can offer taxpayers more certainty than if tax expenditures were subject to





annual review, but can also result in tax expenditures remaining in the tax code long after outliving usefulness.

In general, there is also no control over the amount of foregone revenue that results from a tax expenditure once that provision has become part of the tax code. Finally, the vote requirements for tax expenditures and direct expenditures are different. Tax expenditures that are adopted legislatively (except those adopted as urgency measures) require approval by a simple majority of both houses of the Legislature. A two-thirds vote is required for budgetary appropriations.

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Recent Changes in Tax Expenditures

ables 1 and 2 provide an overview of recent changes in tax expenditure programs. Table 1 lists the tax expenditures that are either repealed or sunset. Table 2 lists the tax expenditures enacted since 1990. This report omits programs with an annual cost of under \$5 million in an effort to focus on tax expenditures of fiscal significance.

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Revenue Estimates

he estimates listed in this report are intended as a general indication of revenue losses from tax expenditure programs. These estimates represent full fiscal year revenue impacts. Thus, if a tax expenditure is enacted part way through a fiscal year, the revenue impact cited is that which resulted during the first *full* year in which the expenditure was effective.

Tables 3 and 4 list the major revenue losses estimated to result from the principal tax expenditures for which estimates can reasonably be developed. Both tables have been limited to tax expenditures of \$10 million or more. Examples of excluded expenditures are personal income tax credits for political contributions, the elderly, and the military, and sales tax exemptions for master records and tapes and for bullion.



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In general, revenue estimates for the Personal Income Tax and Corporation Tax Laws are easier to quantify than those for the Sales and Use Tax Law. Personal income and corporation tax returns contain significant detail regarding different sources of income and types of exemptions, exclusions, deductions, and credits claimed. Thus, tax return data are often available when estimating the fiscal impact of various income and corporate tax expenditure programs. In contrast, returns filed by taxpayers under the Sales and Use Tax Law contain little specific information regarding items purchased from individual retailers. For this reason, independent data sources must be used when estimating the revenue impacts of various sales tax expenditure programs, and the precision of these estimates can be lower than those for the Personal Income and Corporation Tax Laws.

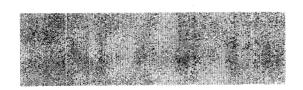
In addition, certain estimates under *all* of the tax laws for which tax expenditure costs are cited can be subject to significant margins of error due to data limitations. Other factors complicating this report's estimates include the effects of tax law interactions and taxpayer reactions to changes in tax law. Therefore, while Tables 3 and 4 display the total value of the major identified expenditures within each major tax, these figures are best viewed as illustrative, only. The fiscal impact of individual tax expenditures cannot be summed to generate the total fiscal impact of all tax expenditures due to the complicating factors of tax law interactions and taxpayer behavioral responses.

State Revenue Losses

Personal Income Tax—The Personal Income Tax Law includes the vast majority of all tax expenditure programs approved to date. It is estimated that special income tax provisions account for approximately \$18.5 billion in annual tax expenditures.

Sales and Use Tax—The Sales and Use Tax Law contains identifiable State tax expenditures worth nearly \$1.2 billion annually. Examples of these include custom computer programs, farm equipment, printed advertising, and motion picture leases.

Corporation Tax—Tax expenditures in the corporation category amount to \$4.4 billion annually. Examples of these expenditures include provisions for S-corporations, research and development, carryover of net operating losses, water's edge election, and manufacturers' investment credit.





Other Taxes — Remaining tax laws are estimated to contain tax expenditure programs valued at slightly above \$160 million. Much of this revenue loss results from motor vehicle fuel tax and insurance tax expenditures.

Local Revenue Losses

able 4 lists revenue losses from the principal exemptions or preferential provisions of property tax law. Property taxes are local taxes, and the legislative exemptions or preferential provisions do not constitute State tax expenditures. Nonetheless, they impact State finances because local tax exemptions reduce property tax allocations to schools. Under current school finance law, the State is generally required to provide the difference in funding between local property tax allocations and school districts' revenue limits. Consequently, each dollar of property tax revenue foregone by schools results in additional State funding through the school apportionment process. Passage of Proposition 98 in November 1988 further impacts state school financing by establishing minimum funding levels for public schools and community colleges, based on both property taxes and State funding. In addition, some property tax exemptions result in State subventions to local governments other than school entities in order to make up some or all of their revenue losses.

Local government revenue losses from identifiable property tax exemptions are estimated at approximately \$200 million, while losses from sales tax expenditures are estimated at \$695 million.

Unidentifiable Revenue Loss Areas

a particular tax expenditure. Fortunately, in most instances, those tax expenditures whose revenue impact cannot be estimated represent unique situations and probably do not result in significant revenue losses. Some examples of tax expenditures for which revenue losses cannot be quantified include sales tax exemptions for livestock and for meals furnished by institutions, and property tax exemptions for intangibles and air carrier ground time.



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TABLE DIE

STATE TAX EXPENDITURES WITH SAVINGS OF \$5 MILLION OR MORE ELIMINATED SINCE 1990

YEAR	CHAPTER	DESCRIPTION	FULL YEAR SAVINGS
1990		None	
1991	117	Personal Income Tax Reduced itemized deductions for high income taxpayers	\$248
	85	Sales and Use Tax ¹ Common carrier fuel (aircraft) ²	106
	85	Newspapers	57
	85	Non-subscription periodicals ³	30
1992	SS	Personal Income Tax Child care credit provisions expired December 31, 1992	106
1993	coccert de proposal de fil de l'activité appliétaciernes a maccamation de	мини-монительно-	erikanskulus oluke tokulustake p ropensional eri tekstörö n tilmaketake kelekulus
1994	Special CA breity (2005, 2007 bost or or programmi (AMERICA)	None	lagidad of Agramminia in the State (State
1995		Personal Income Tax Ridesharing expenses credit expired December 31, 1995	13
1996	oogoo - oogo - oogo oo o	None	ない。 「中心では、一般では、一般では、「一般では、「一般では、「一般では、「一般では、「一般では、「一般では、「一般では、「一般では、「一般では、「一般では、「一般では、「一般では、「一般では、「一般では、「一般では、「一般では、「一般では、」
1997	SS	Personal Income Tax Los Angeles Revitalization Zone incentives expired December 31, 1997	**************************************
	SS	Corporation Tax Los Angeles Revitalization Zone incentives expired December 31, 1997	67

SS=Sunset

Chapter 85, Statutes of 1991, also repealed the exemptions for candy, snack foods, and bottled water. However, these exemptions were reinstated in November 1992 by Proposition 163.



² Chapter 85, Statutes of 1991, repealed the exemptions for air, rail, and watercraft common carrier fuel. Chapter 905, Statutes of 1992, reinstated the exemption for watercraft common carrier fuel and reinstated a partial exemption for aircraft common carrier fuel used on international flights.

Chapter 85, Statutes of 1991, repealed the exemption for all periodicals. Chapter 903, Statutes of 1992, reinstated the exemption for subscription periodicals.

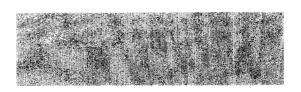


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STATE TAX EXPENDITURES OF \$5 MILLION OR MORE ENACTED SINCE 1990

YEAR	DESCRIPTION F	RST FULL YEAR Cost
ENACTED CHAPTER		
1990	Personal Income Tax	
1347	Stay-at-home parent credit	\$25
	Corporation Tax	
1513	Increased compliance penalties	5
1991	Personal Income Tax	eni-pag. 1. 2 manususpin ausznagos a nna 1986 de distributo a fanta pag. 2000 de
117	Extension of net operating loss (NOL) carryover ¹	45
	Corporation Tax	
117	Extension of net operating loss (NOL) carryover ¹	164
117	Extension of research and development credit	64
	Sales and Use Tax	20
461	Newspapers and periodicals distributed free of charge	20
1992	Personal Income Tax and Corporation Tax	property at the security was the security and the security and the security of the security and the security
17	Establishment of revitalization zone for LA riot area	7
	Sales and Use Tax	
903	Subscription periodicals	10
905	Watercraft common carrier fuel	21
1993	Personal Income Tax	un serial automorphism and <mark>an international and an international serial and an international serial and an international series and an intern</mark>
874	Limited partnerships investment source rule	10
881	Manufacturers' investment credit	32
881	Small business stock exclusion	26
	Corporation Tax	
881	Manufacturers' investment credit	365
1121	Expanded credit union income exemption	13
	Sales and Use Tax	_
881	Manufacturing equipment for start-up firms	10
887	Intangible rights	Unknown
1994	Corporation Tax	adurant artum (1.1.) comunum american militarida est e debut metello e la section de debut metello estado de c
748	Extended and limited the employer child care credit	5
# ## The Control of t		No. thought place and a subdivine when the new commence are subdivined by

¹ The use of net operating loss (NOL) carryovers was suspended for the 1991 and 1992 tax years, and the sunset was extended for five years. The costs represent the first year of extension. Chapter 880, Statutes of 1993, repealed the sunset date.



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TABLE TWO (CONTINUED)

STATE TAX EXPENDITURES OF \$5 MILLION OR MORE ENACTED SINCE 1990

(DOLLARS IN MILLIONS)

YEAR Enacted (CHAPTER	FIRST F DESCRIPTION	ULL YEAR Cost
	and and of the control of the contro		
1996	05.4	Personal Income Tax	\$9
	954	Long-term care deduction	8
	954	Medical savings accounts	8
	954 954	Increased spousal IRAs Educational assistance exclusion	7
	954	Educational assistance exclusion	•
		Corporation Tax	10
	953	Expanded Enterprise Zone program	
	954	Expanded research and development tax credit	22
	954	Reduced minimum franchise tax for new businesses	8
	0.67	Insurance Tax	30
	967	Coverage provided through California Earthquake Authority	30
1997	Jenes Commonweal Control of the Service of the Serv	Personal Income Tax	* 100 min 1
	612	Expanded exclusion of capital gains on the sale of principal	
		residences	105
	612	Expanded IRA provisions including the Roth IRA and	
		education IRA	31
		Corporation Tax	40
	613	Expanded research and development tax credit	46
1998	A STATE OF THE PROPERTY OF THE PARTY OF THE	Personal Income Tax	Handelfreit, VIII on Wild Handersteinen monn men segne gegeber der
	322	Nonrefundable renters' credit	141
	322	Student loan interest deduction	15
	322	Expanded home office deduction	8
	323	Increased health insurance deduction for self-employed	12
	323	Permanent extension of employer child care credits	11
1998	NO THE CONTRACTOR OF THE CONTRACTOR OF THE	Corporation Tax	en genangsa yan annasa munk aba nci (hobbash) (hobb
	322	Joint Strike Fighter credit	61
	323	Increased alternative incremental research and development cred	it 18
	323	Reduced minimum franchise tax for	
		first two years for new, small businesses	11
	323	Expanded the manufacturers' investment credit to	
		computer programming and software activities	7
		Sales and Use Tax	
	323	Expanded and extended exemption for property used in space flig	ghts 8
	323	Partial exemption for property used in teleproduction or postprod	uction 8
	323	Exemption for non-annual plants	7
1999	ON A SOUTH COMES MANUAL OF THE PROPERTY OF THE	Personal Income Tax	en al arabaco nel araban de la composito de la
	117	Increased health insurance deduction for self-employed taxpayer	s 19
		Corporation Tax	
	64	Minimum franchise tax exemption for	
		first two years for new corporations	58
		Increased research and development credit	

TABLE TWO CONTINUES >



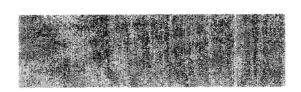


TABLE TWO (CONTINUED)

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STATE TAX EXPENDITURES OF \$5 MILLION OR MORE ENACTED SINCE 1990

YEAR ENACTED CHAR	PTER	DESCRIPTION	FIRST	FULL YEAR
		T.		
2000	7.5	Personal Income Tax		\$200
	75 1.4	Teacher retention credit		189
	14	Refundable child care credit		38
	07	Long-term care credit		
10	07	Graduate student exclusion		10
		Corporation Tax		
10	07	Increased research and development tax credit		33
10	07	Increased net operating loss carryover		5
		Sales and Use Tax		
5	99	Deduction for worthless accounts		at least 6
	07	Rural investment exemption		5
2001	ngad manad ng myah-mi - sah	Personal Income Tax		TO STANKE
	12	Solar energy systems tax credit		7
		Corporation Tax		
	12	Solar energy systems tax credit		13
		C. L I flow Torn		
4.1	E C	Sales and Use Tax		36
	56	Exemption for farm machinery and equipment		36 14
	56	Exemption for diesel fuel used in agriculture		7
1:	56	Exemption for liquefied petroleum gas		/



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TABLE THREE

MAJOR IDENTIFIABLE STATE TAX EXPENDITURES OF \$10 MILLION OR MORE, 2002-03

(DOLLARS IN MILLIONS)

EU		
PERSONAL INCOME TAX RECURSION OF THE PROPERTY OF THE PROPERTY OF TAX OF THE PROPERTY OF THE P	Cost	
Home mortgage interest deduction	\$3,260	
Exclusion of pension contributions and earnings	3,240	
Exclusion of employer contributions to health plans	2,830	
Exclusion of capital gains at death	1,480	
Charitable contributions deduction	1,160	
Exclusion of Social Security benefits	1,000	
Exclusion of investment income on life insurance and annuity contracts	900	
Real estate and other taxes deduction	885	
Exclusion of capital gains on sale of principal residence	700	
Exclusion of benefits provided under cafeteria plans	470	
Employee business and miscellaneous expenses deduction	465	
Contributions to self-employed retirement plans	300	
Exclusion of compensation for injuries or sickness	265	
Exclusion of miscellaneous fringe benefits	220	
Carryover of net operating losses	220	
Household and dependent credit		
Teacher retention credit	175	
Medical and dental expenses deduction	125	
Deduction of health insurance paid by self-employed	100	
Exemption for senior citizens	98	
Renters' credit	95	
Exclusion of employer contributions to life insurance	89	
Contributions to IRAs	59	
Exclusion of State lottery winnings	52	
Exclusion of unemployment insurance benefits	52	
Exclusion of scholarship/fellowship income	52	
Manufacturers' investment credit	49	
Exclusion for small business stock	48	
Exclusion of meals and lodgings furnished by non-military employer	33	
Research and development credit	33	
Exclusion of employer-provided child care	30	
Enterprise Zone hiring and sales tax credits		
Exclusion of foster care payment		
Limited partnerships investment source rule		
Exclusion for graduate education		
Solar energy credit		
Subchapter S-corporations ¹		
Total		

TABLE THREE CONTINUES

The gain represents the net result after allowing for the pass-through of net business gains and losses to shareholders, as well as the impact of business source income to nonresident shareholders.



TABLE THREE (CONTINUED)

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FIII YEAR

MAJOR IDENTIFIABLE STATE TAX EXPENDITURES OF \$10 MILLION OR MORE, 2002-03

(DOLLARS IN MILLIONS)

SALES AND USE TAX 1	FULL YEAR Cost
Vessels and aircraft ² \$	300 to \$600
Cargo and returnable containers ²	100 to 500
Custom computer programs	
Partial exemption for vending machine sales	
Exemption for farm equipment	
Printed advertising ³	
Newspapers and periodicals distributed free of charge ³	10 to 50
Student meals ³	10 to 50
Motion picture production services	28
Leases of motion pictures	
Exemption for diesel fuel used in agriculture	_ 17
Watercraft common carrier fuel	11
Subscription periodicals	10
Total ⁴	\$1,190
_ocal government revenue loss (2.92 percent average rate) ⁵	
	FULL YEAR
	FULL YEAR Cost
CORPORATION TAX Subchapter S-corporations	FULL YEAR COST \$1,750
CORPORATION TAX Subchapter S-corporations Carryover of net operating losses	*\$1,750 840
CORPORATION TAX Subchapter S-corporations Carryover of net operating losses Research and development credit	\$1,750 840 510
CORPORATION TAX Subchapter S-corporations Carryover of net operating losses Research and development credit Water's edge election	\$1,750 840 510 340
CORPORATION TAX Subchapter S-corporations Carryover of net operating losses Research and development credit Water's edge election Manufacturers' investment credit	\$1,750 840 510 340 320
Subchapter S-corporations Carryover of net operating losses Research and development credit Water's edge election Manufacturers' investment credit Expensing costs of research, exploration, and development	\$1,750 840 510 340 320 150
Subchapter S-corporations Carryover of net operating losses Research and development credit Water's edge election Manufacturers' investment credit Expensing costs of research, exploration, and development Corporations exempt from minimum tax	\$1,750 840 510 340 320 150
CORPORATION TAX	\$1,750 840 510 340 320 150 125
Subchapter S-corporations Carryover of net operating losses Research and development credit Water's edge election Manufacturers' investment credit Expensing costs of research, exploration, and development Corporations exempt from minimum tax Charitable contributions deduction	\$1,750 840 510 340 320 150 125 115 82
Subchapter S-corporations Carryover of net operating losses Research and development credit Water's edge election Manufacturers' investment credit Expensing costs of research, exploration, and development Corporations exempt from minimum tax Charitable contributions deduction Enterprise Zone hiring and sales tax credits	\$1,750 840 510 340 320 150 125 115 82 42

5.00 percent General Fund rate.

Dependent on the volume of purchases that could be shifted out of state. The value of the sales tax exemption for vessels and aircraft is believed to be in the range of \$300 million to \$600 million annually. The value of the sales tax exemption for cargo and returnable containers is believed to be in the range of \$100 million to \$500 million annually.

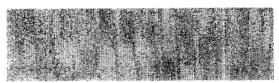
Los Angeles revitalization zone incentives

Credit union treatment

Believed to be in the range of \$10 million to \$50 million annually.

⁴ Assumes a mid-range estimate for tax expenditures whose value is unknown.

Includes 0.50 percent Local Revenue Fund, 0.50 percent Local Public Safety Fund, 1.25 percent Uniform Local Sales Tax, and 0.67 percent average county add-on rate.



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TABLE THREE CONTINUES >

2002-03

TABLE THREE (CONTINUED)

MAJOR IDENTIFIABLE STATE TAX EXPENDITURES OF \$10 MILLION OR MORE, 2002-03

(DOLLARS IN MILLIONS)

· · · · · · · · · · · · · · · · · · ·	FULL YEAR
OTHER TAXES	Cost
、2000年大大学的企业,1980年代,19	COLOR SALVES A COMMENT THE COMMENT OF THE COLOR OF THE CO
Motor Vehicle Fuel Tax	
Aircraft jet fuel used by common carriers and military	. \$71
Diesel and use fuel used by transit districts and schools	21
Total	\$92
Insurance Tax	
Pension and profit-sharing plans	\$32
Earthquake	10
Total	\$42
Cigarette Tax	
Sales to the military	\$31

TABLE FOUR

MAJOR IDENTIFIABLE PROPERTY TAX EXPENDITURES OF \$10 MILLION OR MORE, 2002-03

F	ULL YEAR			
	Cost			
是我们是我们,我们还是我们的人们的人们的,我们就是我们的人们的人们的人们的人们的人们的人们的人们的人们的人们的人们的人们的人们的人们	CONTRACTOR OF THE STATE OF THE	639 (8)(83241435		
Computer programs	\$101			
Open space and historical property	97			
Total	\$198			

